ST 02-14
Tax Type: Sales Tax
Issue: Audit Methodologies and/or Other Computational Issues
Unreported/Underreported Receipts (Fraud Application)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS,	No. 01-ST-0000 01-ST-0000
v.	IBT# 0000-0000 (TKK Corp.) NTL 00 0000000000000 IBT# 0000-0000 (TNDE Corp.) NTL 00 0000000000000
ABC Corp., and XYZ Corp., Taxpayers	**Ted Sherrod Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Mark A. Byrd of Byrd & Taylor, for ABC Corp. and XYZ Corp.; Special Assistant Attorneys General Jessica Arong and Mark Dyckman on behalf of the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to ABC Corp.'s timely protest of Notice of Tax Liability (NTL) 0000000000000 dated September 28, 2000, and pursuant to XYZ Corp.'s timely protest of NTL 00 0000000000000 dated October 10, 2000, for Retailers' Occupation Tax and related taxes. Both taxpayers are owned in part by John Doe. The issues in this case, as specified in the pre-trial order, are: 1) whether the

methodology used by the Department of Revenue ("Department") to determine the taxpayer's tax liability at issue in this case was reasonable and proper; and, 2) if so, whether a fraud penalty was properly applied in this case. Following the submission of all evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department as to both taxpayers and on both issues.

Findings of Fact:

Facts Regarding XYZ Corp. (hereinafter "XZY")

1. The Department's prima facie case against XZY ("taxpayer"), including all jurisdictional elements, was established by the admission into evidence of the SC-10-K, Audit Correction and/or Determination of Tax Due ("correction of returns"), showing tax due of $39,976, and penalties in the amount of $27,155 for the audit period January, 1997 through March, 1999. Dept. Ex. 8.[1]

2. Included in the assessment is a fraud penalty assessed under 35 **ILCS** § 120/4 for the aforementioned audit period. Dept. Ex. 8.

3. XZY, a business registered as a corporation in Illinois that is located in Anywhere, Illinois, is engaged in the retail business of selling liquor, beer, wine, wine coolers, soft drinks, cigarettes, food and other miscellaneous items. Tr. pp. 25, 27, 66; Dept. Ex. 9, 10, 11.

4. XZY was acquired by John Doe in 1995, and is owned by John Doe, its President and Ron Doe, John Doe's brother, its secretary; Ron Doe was employed as a manager of XZY in 1995 and has served continuously in this position since 1997. Tr. pp. 135, 230; Dept. Ex. 10, 14.

5. XZY is required to file sales tax returns on a monthly basis. Dept. Ex. 10.

6. In 1999, XZY was the subject of an investigation by special agent Michael Hoff of the Department's Bureau of Criminal Investigation, and other employees of the Department for the tax periods set forth above. Tr. pp. 18, 19, 20, 21; Dept. Ex. 13, 14.

7. During his investigation, special agent Hoff obtained a record of all of XZY' purchases of liquor during the audit period at issue by circularizing this taxpayer's vendors (i.e. by issuing administrative supoenas to the taxpayer's wholesale vendors demanding that a monthly total of sales be provided to the Department). Tr. pp. 24, 26, 27; Dept. Ex. 14.

8. Special agent Hoff and other Department employees conducted an initial on-site inspection of the taxpayer in June, 1999; in the course of this inspection, Ron Doe, manager of XZY provided special agent Hoff with a daily sheet for June 21, 1999 showing 95% of the day's sales were high tax items consisting of liquor, beer, wine, cigarettes and soft drinks taxable at 6.25% rather than at the 1% rate applicable to low tax items such as food not for immediate consumption and drugs; the daily sheet showed gross sales of $923.31, high tax collected of $44.23 and low tax collected of 36 cents; this daily sheet reflected the inventory at XZY observed by Mr. Hoff. Tr. pp. 20, 21, 22, 25, 26, 32, 33, 34; Dept. Ex. 14.

9. Subsequent to this visit, special agent Hoff obtained XZY' sales tax returns and computerized spreadsheets prepared by this taxpayer, which were used by the taxpayer to prepare sales tax returns for the audit period in controversy, showing that

[1] Unless otherwise noted, findings of fact apply to the audit period.

only 30% of the taxpayer's sales were reported as high tax items; however special agent Hoff was provided with no sales sheets or sales journals, register tapes or other books and records to support the sales reported in the spreadsheet and returns because these were destroyed after the sales tax returns were prepared. Tr. pp. 24, 26, 29, 30, 32, 34, 47, 54, 55.

10. Special agent Hoff compared total liquor and beer sales reported by XZY' vendors pursuant to the Department's administrative supoenas, to total sales reported on the taxpayer's sales tax returns which were prepared by John Doe, XZY' President; based on this comparison, special agent Hoff found that this taxpayer's purchase of high tax rate items totaled $590,831, and the taxpayer's high rate sales reported on its tax returns were $171,024, resulting in under reported high tax sales of $419,807 and underreported sales tax of $26,238; special agent Hoff did not apply any mark up in arriving at a determination of underreported sales tax. Tr. pp. 24, 26, 27, 28, 29, 32, 47, 86, 87; Dept. Ex. 14.

11. After completing his investigation, special agent Hoff turned over his findings to the Attorney General's office; subsequently, XZY and its President, John Doe, were criminally charged with filing fraudulent retailers' occupation tax returns for the tax periods in controversy. Tr. pp. 30, 31, 57, 58, 154, 155; Dept. Ex. 14.

12. XZY and John Doe, its President, pled guilty and entered into a plea agreement; Mr. Ron Doer pled guilty to a class A misdemeanor, was placed on 24 months probation, and agreed to make restitution of unpaid retailers' occupation taxes to the Department in the amount of $19,375; XZY was also found guilty of a class B felony and placed on 12 months probation. Tr. pp. 57, 58, 154, 155, 156, 157, 158; Dept. Ex. 13.

13. The Bureau of Criminal Investigation turned special agent Hoff's report over to the Department's audit bureau for review and application of a mark up reflecting the taxpayer's profit margin, penalties and interest. Tr. pp. 57, 64, 65; Dept. Ex. 14.

14. Mr. Joseph Cotton, an auditor with the Department's audit bureau, was assigned to audit XZY in January, 2000; during the course of this audit Mr. Cotton examined purchase invoices, including invoices provided by Smith, an attorney that represented the taxpayer in its criminal investigation, information on liquor and beer purchases obtained by the Bureau of Criminal Investigation, information on sales prices obtained during a store visit and the taxpayer's sales tax returns; as a result of this investigation, Mr. Cotton found that XZY had underreported its sales tax by 58% during the audit period in controversy. Tr. pp. 64, 65, 66, 67, 68, 69, 72, 73, 75, 76; Dept. Ex. 9, 10, 11.

15. Mr. Cotton determined XZY' retailers' occupation tax liability by applying a mark up to its inventory of high tax rate items shown in the Bureau of Criminal Investigation's records, with the mark up applied being determined by comparing the cost of items of inventory (identified from March 2000 invoices) to the sale price of these items observed during Mr. Cotton's visit to XZY in May, 2000; Mr. Cotton also gave credit for overpayment of tax on low tax items, and tax paid on high tax items, with the fraud penalty imposed by Mr. Cotton being applied to the net tax due. Tr. pp. 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 126; Dept. Ex. 9, 10, 11.

16. In response to Mr. Cotton's request for books and records, XZY did not produce any records this taxpayer was required to retain by 35 **ILCS** 120/7; it did not produce any Z tapes[2], register tapes, daily sales reports or any other source documentation to substantiate sales reported on its sales tax returns for the tax periods in controversy; these items were destroyed after the sales tax returns were prepared. Tr. pp. 79, 80, 148, 149; Dept. Ex. 14.

Facts Regarding ABC Corp.

17. The Department's prima facie case against ABC Corp. ("taxpayer") including all jurisdictional elements, was established by the admission into evidence of the correction of returns, showing tax due of $67,679 and penalties in the amount of $45,912 for the audit period January, 1997 through March, 1999. Dept. Ex. 1.

18. Included in the assessment was a fraud penalty assessed under 35 **ILCS** § 120/4 for the aforementioned audit period. Dept. Ex. 1.

19. ABC Corp. (hereinafter "ABC"), a business registered as a corporation in Illinois that is located in Anywhere, Illinois, is engaged in the business of selling liquor, beer, soft drinks, cigarettes, food and other miscellaneous items. Dept. Ex. 2, 3, 4.

20. ABC is required to file sales tax returns on a monthly basis. Dept. Ex. 3.

21. ABC was acquired by John Doe in 1995; it is owned by John Doe, its President, who is also an owner of XZY, and Joe Blow, its secretary; Joe Blow has also been a manager of ABC since 1995. Tr. p. 202; Dept. Ex. 3, 7.

22. In 1999, ABC was the subject of an investigation by Bureau of Criminal Investigation special agents Michael Hoff and Keith Quintavalle, and revenue auditor Sandra

[2] Z tapes are a summary of the day's register tapes. Tr. p. 79.

Kreml, an employee of the Department (hereinafter "BCI agents"), for the audit period set forth above. Tr. pp. 20, 22, 23; Dept. Ex. 7.

23. During their investigation, the BCI agents obtained records of all of ABC's purchases of liquor and beer during the audit period set forth above from ABC's wholesale vendors by issuing an administrative supoena demanding that this information be provided to the Department. Tr. pp. 66, 76; Dept. Ex. 4, 7.

24. The BCI agents conducted an initial on-site inspection of the taxpayer on June 23, 1999; during this visit they determined that ABC did not sell low tax grocery items. Dept. Ex. 7.

25. The BCI agents obtained ABC sales tax returns and computerized spreadsheets prepared by John Doe, ABC's President; even though ABC was not engaged in the sale of grocery items, the taxpayer's returns for the audit period in controversy showed a 70% low tax rate; the BCI agents were provided with no register tapes, daily sales reports or any other source documentation to support the sales shown on the taxpayer's sales tax returns and in spreadsheets used to prepare them because these records were destroyed after the sales tax returns were prepared. Tr. pp. 47, 148, 149, 154, 203, 204; Dept. Ex. 7.

26. The BCI agents compared total liquor and beer sales reported by ABC's vendors pursuant to the Department's administrative supoena, to total sales of these items reported on ABC's sales tax returns; based on this comparison, the BCI agents determined that ABC's purchases of high rate items totaled $1,170,891, while this taxpayer's high rate sales reported on its tax returns were $568,814 resulting in underreported sales of high rate inventory of $602,077 and underreported sales tax of

$37,629.81; the BCI agents did not apply any mark up in arriving at a determination of underreported sales and tax. Tr. pp. 47; Dept. Ex. 7.

27. After completing their investigation, the BCI agents turned their findings over to the Attorney General's office; subsequently, ABC and its President, John Doe, were criminally charged with filing fraudulent retailers' occupation tax returns for the tax periods in controversy. Tr. pp. 154, 155; Dept. Ex. 6, 7.

28. ABC and John Doe, its President, entered into a plea agreement pursuant to which John Doe pled guilty to a class A misdemeanor and agreed to make restitution of unpaid retailers' occupation taxes to the Department in the amount of $37,679.91; ABC was found guilty of a Class B felony and placed on 12 months probation. Tr. pp. 156, 157, 158, 161; Dept. Ex. 6.

29. The Bureau of Criminal Investigation turned over the report of its investigation of ABC to the Department's audit bureau in January, 2000. Tr. pp. 64, 65.

30. Mr. Joseph Cotton, the Department's auditor, was assigned to audit ABC in January, 2000; during the course of this audit Mr. Cotton examined purchase invoices, including invoices provided by Smith, an attorney that represented the taxpayer in its criminal investigation, information on liquor and beer purchases obtained by the Bureau of Criminal Investigation, information on sale prices obtained during a store visit and this taxpayer's sales tax returns; as a result of this investigation, Mr. Cotton found that ABC underreported its sales tax by 33% during the audit period in controversy. Tr. pp. 64, 65, 72, 73, 75, 76, 109, 110; Dept. Ex. 3, 4.

31. Mr. Cotton determined ABC's retailers' occupation tax liability by applying a mark up to its inventory of high tax rate items shown in the Bureau of Criminal Investigation's records, with the mark up applied being determined by comparing the cost of items of inventory (identified from March, 2000 invoices) to the sale price of these items observed during Mr. Cotton's visit to ABC in May, 2000; Mr. Cotton also gave ABC credit for overpayment of tax on low tax items, and tax paid on high tax items, with the fraud penalty imposed by Mr. Cotton being applied to the net tax due. Tr. pp. 65, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 126; Dept. Ex. 2, 3, 4.

32. In response to Mr. Cotton's request for books and records, ABC did not produce any records it was required to retain by 35 **ILCS** 120/7; it did not produce any Z tapes, register tapes, daily sales tax reports or other source documentation to substantiate sales reported on its sales tax returns for the tax periods in controversy because these were destroyed after tax returns were prepared. Tr. pp. 79, 80, 148, 149; Dept. Ex. 7.

Conclusions of Law:

Pursuant to 35 **ILCS** 120/4, each taxpayer's correction of returns submitted as the Department's exhibits 1 (regarding ABC) and 8 (regarding XZY) is prima facie correct and constitutes prima facie evidence of the correctness of the amount of tax due as shown therein. Once the Department establishes the prima facie correctness of the amount of tax due through the admission into evidence of the correction of returns, the burden shifts to the taxpayer to show that this determination is incorrect. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). On examination of the record in this case, I conclude that neither XZY nor ABC has presented sufficient evidence to overcome the Department's prima facie case. Accordingly, for the reasons given below, the aforementioned NTLs should be affirmed in their entirety.

ISSUE # 1

The first issue specified in the pre-trial order is whether the methodology used to determine the taxpayer's tax liability at issue in this case was reasonable and proper. The record indicates that both of the taxpayers are engaged the business of selling tangible personal property at retail. Dept. Ex. 1, 3, 8, 10. The Retailers' Occupation Tax Act, 35 120/1 *et seq.* (hereinafter "ROTA") has a specific requirement for maintaining books and records that is applicable to such retailers, which provides as follows:

> Every person engaged in the business of selling tangible personal property at retail in this State shall keep records and books of all sales of tangible personal property, together with invoices, bills of lading, sales records, copies of bills of sale, inventories prepared as of December 31 of each year or otherwise annually as has been the custom in the specific trade and other pertinent papers and documents.
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> 35 **ILCS** 120/7

A taxpayer's duty to keep such books and records is mandatory. Smith v. Department of Revenue, 143 Ill. App. 3d 607 (5th Dist. 1986). When a taxpayer fails to maintain such records, and does not supply the Department with documentation to substantiate its gross receipts, the Department is justified in using other reasonable methods to estimate the taxpayer's revenues. Young v. Hulman, 39 Ill. 2d 219 (1968); Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1st Dist. 1978). In this case, because both taxpayers failed to retain the records required by 35 **ILCS** 120/7, the Department's Bureau of Criminal Investigation obtained third party records to estimate the amount of each taxpayer's gross purchases and gross receipts from high tax rate sales during the audit period. To arrive at a tax liability, the Department's auditor applied a mark up to purchases of high tax rate merchandise[3] to determine both taxpayers' gross receipts from sales of liquor, beer and other high tax rate inventory. The taxpayer contests the use of this methodology.

The method used by the Department in this case must only meet a minimal standard of reasonableness. Smith, *supra*; Masini, *supra*; Mel Park Drugs, Inc. v. Dept. of Revenue, 218 Ill. App.

[3] High tax rate merchandise includes alcoholic beverages, soft drinks, and food prepared for immediate consumption, which are taxable at the state's regular tax rate of 6 ¼%; food for human consumption to be

3d 203 (1st Dist. 1991). Moreover, the Department's determination is presumed correct, and the Department is not required to substantiate the basis for the corrected return. A.R. Barnes & Co., *supra.* Accordingly, proof that an audit determination meets a minimal standard is not required unless a taxpayer has introduced evidence sufficient to rebut the Department's prima facie case. *Id.* Hence, to decide the first issue in this case, it must be determined whether the taxpayer has presented evidence sufficient to overcome the presumed correctness of the Department's mark up calculation used to arrive at the taxpayer's underreported sales tax.

To overcome the Department's prima facie case, a taxpayer must present consistent, probable evidence closely identified with its books and records. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968); Central Furniture Mart v. Johnson, 157 Ill.

App. 3d 907 (1st Dist. 1987); Vitale v. Department of Revenue, 118 Ill. App. 3d 210 (3d Dist. 1983); A.R. Barnes & Co., *supra.* The taxpayers attempt to meet this burden through testimony intended to establish that it was impossible for either of these businesses to attain the profit margins attributed to them by the auditor's calculations. Tr. pp. 164, 165, 166, 167, 168, 169, 170, 171, 172, 173, 174, 175, 176, 177, 215, 216, 217, 218, 219, 220, 221, 222, 223, 224, 225, 226, 227, 228, 229, 237, 238, 239, 240, 241, 242, 243, 244, 245, 246, 247. However, during their testimony, the witnesses appearing on each taxpayer's behalf presented no books or records to corroborate their allegations regarding the inaccuracy of the auditor's estimate of profit margins. Nor did these witnesses attempt to base their conclusions on any other documents shown to be related to the business' books and records.[4]

While the taxpayers have provided an explanation of why the profit margins of XZY and ABC might be lower than those attributed to these businesses by the Department, this testimony does not prove that the auditor's methods for determining the inventory mark-up were unreasonable. Case law in Illinois clearly indicates that merely denying the accuracy of the Department's assessments, offering alternative hypotheses or arguing that its audit methodology is flawed is not enough to overcome the Department's prima facie case. A.R. Barnes & Co., *supra;* Central Furniture Mart, *supra*; Quincy Trading Post Inc. v. Department of Revenue, 12 Ill. App. 3d

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consumed off the premises where it is sold is taxable at a reduced rate of 1%. 35 **ILCS** 120/2-10; 86 Ill. Admin. Code § 130.310**.**

[4] The only documentary evidence introduced into the record by the taxpayers are spreadsheets purportedly used to prepare the taxpayers' sales tax returns. Taxpayers' Ex. 1, 2. However, the taxpayers presented no evidence showing that these spreadsheets were based on the taxpayers' general ledgers, daily sales sheets, register receipts or any other books and records.

725 (4th Dist. 1973). A taxpayer can overcome the Department's prima facie case only by producing competent evidence closely identified with the taxpayer's books and records. Copilevitz, *supra;* A.R. Barnes & Co., *supra;* Central Furniture Mart, *supra*; Vitale, *supra.* In the instant case, the taxpayer has presented no such documentary evidence to show that the Department's determination was arbitrary, capricious or unreasonable. Oral testimony without corroborating books and records is insufficient to overcome the Department's prima facie case. Mel Park Drugs, *supra.* The unsubstantiated oral testimony of the taxpayers' witnesses, based on the these witnesses' recollections is simply not sufficient to meet the taxpayers' burden in this case. *Id.*

The taxpayers also question the auditor's use of March, 2000 purchase prices to determine the cost of high tax rate merchandise to which a mark-up was applied since 2000 prices did not reflect the cost of merchandise during the audit period in controversy (January, 1997 through March, 1998). Tr. pp. 97, 98, 99, 102, 118. March, 2000 purchase prices were used because March, 2000 invoices were the only invoices forwarded to the Department by the taxpayers' attorney. Dept. Ex. 3, 10. Moreover, the auditor did not have sale prices for years prior to 2000; these were not provided by the taxpayers since no mark up was determined during the Department's criminal investigation preceding the audit. Tr. p. 47. Consequently, the auditor used sale prices observed during a visit to the taxpayers' stores in May, 2000. Dept. Ex. 4, 11. Comparing 2000 sale prices to pre-2000 purchase prices clearly would have produced a distorted result.

During the hearing, neither taxpayer produced any evidence other than unsubstantiated testimony to prove that the 2000 prices used by the auditor to arrive at a mark up were incorrect. To prevail, the taxpayers needed to present documentary evidence, or evidence closely associated with books and records showing the sale prices of high rate merchandise during the audit period in controversy, and invoices showing the actual purchase price of inventory during this period. However, neither taxpayer ever attempted to make any such showing during the hearing. Instead, their witnesses relied upon uncorroborated oral testimony, which was not substantiated in any way, to establish the inaccuracy of the Department's methodology. Hence, the taxpayers' argument

ignores the obvious fact that the proposed assessment is of necessity based upon an estimate of the taxpayers' inventory cost and sale prices during the audit period because the taxpayers failed to provide this information. Under such circumstances, the ROTA expressly permits the Department to correct the taxpayers' returns "according to its best judgement and information". 35 **ILCS** 120/4.

The auditor was provided with insufficient information to compare purchase prices and sale prices during the audit period in controversy. Accordingly, the March, 2000 inventory prices constituted the best available evidence of inventory costs during the audit period. Moreover, these costs, when compared to sale prices observed during the auditor's visit to the stores in May, 2000, constituted the best available evidence of the taxpayers' profit margins and mark up during this period.

The taxpayers also question the reasonableness and fairness of the sampling techniques used by auditor; they claim that projections based on the group of items randomly selected for investigation distorted the taxpayers' mark up. Tr. pp. 99, 100, 101, 102, 103, 104, 105, 106, 107, 108, 259, 260, 261, 262, 264, 265. However, the courts have held that the type of discretion exercised by the auditor in arriving at a method to assess tax in this case is authorized under the broad powers granted the Department to administer the state's tax laws. Clark Oil & Refining Corporation v. Johnson, 154 Ill. App. 3d 773 (1st Dist. 1987). Moreover, the taxpayers failed to present any evidence other than oral testimony showing that the auditor's sampling techniques produced an incorrect result and therefore have not shown that the auditor's methods were unreasonable. Mel Park Drugs, *supra.*

In sum, I find that the evidence presented by the taxpayers to rebut the Department's case, consisting of the testimony of their owners, officers and managers, was insufficient to rebut the presumed correctness and reasonableness of the Department's methodology and calculations. Masini, *supra;* Vitale, *supra;* A.R. Barnes & Co., *supra;* Fillichio v. Department of Revenue, 15 Ill. 2d

327 (1958). Absent any competent evidence sufficient to controvert the Department's prima facie case, the accuracy of the Department's methodology must be confirmed and the Department's determination as reflected in the correction of returns must be sustained. *Id*.

ISSUE #2

The second issue to be decided is whether the under-reporting of sales determined by the Department was due to fraud. Where civil fraud under section 4 of the Retailers' Occupation Tax Act (35 **ILCS** § 120/4) is alleged, the Department must show intent. Vitale at 213. Intent for this purpose can be inferred from circumstantial evidence. *Id*. The taxpayers argue that the actions of their employees during the audit negate any inference of an intent to engage in fraudulent conduct. They point out that the taxpayers' employees voluntarily tendered information, including purchase invoices, that was used by the Department's special agents and auditor to arrive at each taxpayer's liability. Tr. pp. 265, 266, 267, 268. They suggest that, had there been a deliberate scheme to defraud the state, documents used to assess the taxpayers would have been destroyed or not maintained. *Id*. Accordingly, the taxpayers ask this tribunal to infer from the taxpayers' willingness to disclose information useful in determining the taxpayers' liability that the taxpayers did not intend to commit a fraud.

The taxpayers' argument assumes that the taxpayers' managers and employees were aware of fraudulent conduct. However, the record indicates that Mr. John Doe, who had an ownership interest in both taxpayers, was solely responsible for preparing the taxpayers' sales tax returns. Tr. pp. 32, 137; Dept. Ex. 7, 14. By their own admission, neither Joe Blow, the manager of ABC, nor Ron Doe, the manager of XZY, knew anything about this. Tr. pp. 206, 207, 234, 235. Nor is there any evidence to suggest that any of the taxpayers' other employees were aware of how the taxpayers' sales tax returns were being prepared. Obviously, not being aware of the underreporting of sales taxes on the taxpayers' returns, the taxpayers' managers and employees would have had no reason

not to cooperate with the Department's personnel. Consequently, their willingness to cooperate does not prove the absence of intent to fraudulently report sales taxes.

Moreover, under Illinois case law, it is not necessary to find evidence of conduct suggesting a conspiracy to commit a fraud to support an inference of fraudulent intent. The courts have found the necessary intent without analyzing this type of evidence. In Vitale, *supra*, the court found the necessary intent from a number of facts having nothing to do with any conduct by the taxpayer's managers and employees during the audit. Evidence found sufficient to support a finding of fraud in this case consisted on the following: the taxpayer had understated his gross receipts by as much as 200%; in one year the taxpayer's purchases exceeded his sales by 46%; finally, the taxpayer failed to maintain business records. Vitale at 213.

In this case, there are a number of factors that show the taxpayers' fraudulent intent. Specifically, XZY understated receipts from high tax rate sales (before any mark up) by over 300% for 1997, over 200% for 1998 and over 150% for 1999. Dept. Ex. 14. Moreover, ABC understated receipts (before any mark up) by over 125% in 1997, by nearly 100% in 1998 and by over 100% in 1999. Dept. Ex. 7. The high rate sales taxes reported on the taxpayers' sales tax returns were understated by 55% (in the case of ABC), and 33% (in the case of XZY). Tr. p. 75. Neither taxpayer retained books and records, as required by 35 **ILCS** 120/7. Moreover, the taxpayers' underreporting of sales and taxes, and failure to maintain books and records prevailed throughout the 27 month audit period. This pattern of conduct is circumstantial evidence of the taxpayers' intent to defraud. Finally, each of the taxpayers was convicted of a felony for filing fraudulent tax returns, and John Doe, President and an owner of both taxpayers, confessed and was ordered to pay over $19,375 (in the case of XZY), and $37,679.91 (in the case of ABC) in restitution. These factors constitute clear and convincing circumstantial evidence of an intent to commit fraud. Therefore, the Department's assessment of fraud penalties must be sustained.

The taxpayers attribute their noncompliance to erroneous instructions to employees running the taxpayers' stores by Mr. John Doe. Tr. pp. 143, 144. Mr. Kabir testified that he was improperly instructed to treat beer as a low tax item by owners of a

retail business he acquired before becoming an owner of the taxpayers. Tr. p. 144. He testified that this misunderstanding was communicated to his store managers and employees (Tr. pp. 144, 145), and both Joe Blow and Ron Doe corroborated this testimony. Tr. pp. 207, 232, 233. However, there is strong circumstantial evidence suggesting that sales tax results were being properly segregated between high tax rate and low tax rate items at the point-of-sale by both taxpayers during the audit period.

The daily report of sales activity at XZY on June 21, 2000, which was produced during special agent Hoff's initial visit to this taxpayer, indicates $923.31 in gross sales for the day, high tax collected of $44 and low tax collected on only $.36. [5] Tr. pp. 33, 34; Dept. Ex. 14. Since special agent Hoff's visit took place shortly after the end of the audit period, this evidence suggests that Ron Doe, who prepared this daily report (Dept. Ex. 14), was indeed aware of the correct manner in which to treat beer and other high tax rate items. In light of this evidence, I do not find John Doe's explanation of the reason for the taxpayers' noncompliance to be credible since there is no evidence that anyone other than John Doe trained his managers and other employees. [6]

WHEREFORE, for the above stated reasons, it is my recommendation that NTL 00 0000000000000 (regarding ABC) and NTL 00 0000000000000 (regarding XZY), including the assessment of fraud penalties contained therein, be upheld in full.

[5] While there is evidence that the taxpayers ultimately began correctly reporting receipts from high tax items (Tr. p. 152), there is also evidence in the record that these compliance improvements were not made until July, 1999, and had not been instituted at the time the Department's criminal investigators conducted their initial site visits in June, 1999. Tr. pp. 77, 78, 79.

[6] It should also be noted that Jane Doe, the day time cashier at ABC, was also able to properly identify low tax items as candy and potato chips during the BCI agents' initial visit in June, 1999, at the beginning of their criminal investigation. Dept. Ex. 7.

Ted Sherrod
Administrative Law Judge

Date: April 5, 2002